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## **THE DEVELOPMENT OF THE JUDICIAL DEFINITION OF MATERIALITY**

*Abstract:* Determining what should be considered a material item has been a problem for both the accounting profession and the courts. By reviewing the court cases involving the issue of materiality, the authors have determined where differences in the materiality standard as applied by the courts exist. The judicial definition of materiality has developed over time, and current trends with important variations are observed. Based upon the authors' analysis, the following judicial definition of materiality, with its possible variations, is suggested: Would the reasonable (or speculative) investor (or layman) consider important (or be influenced by) this information in determining his course of action?

Finding a general definition for materiality has been difficult for both the accounting profession and the courts of the United States. The courts have been criticized for not developing a concise definition of materiality. [Reckers, et. al., 1985; Jeffries, 1981]. However, the accounting profession itself has not been able to precisely define what is or is not material. Without an all-purpose definition of materiality, the courts have grappled with its meaning on a case-by-case basis. The result has been confusion over some elements of the definition. This paper will review the cases involving materiality and the evolution of the definition of materiality in the courts. Based upon an analysis of the court opinions, the varying standards which have been applied by the courts will be explained.

### **THE ACCOUNTANT'S VIEW OF MATERIALITY**

Accountants have recognized that the profession would benefit if a general definition of materiality could be developed. In 1973, the issue of materiality was one of the original items for consideration by the newly-formed Financial Accounting Stan-

dards Board (FASB). The Board's conclusions on materiality criteria were issued in 1980 in its Statement of Financial Accounting Concepts (SFAC) No. 2, "Qualitative Characteristics of Accounting Information." The FASB announced that it would not attempt to codify basic rules for materiality, stating, "The Board's present position is that no general standards of materiality can be formulated to take into account all the considerations that enter into an experienced human judgment" [FASB, 1980, p. xiii]. The Board instead issued this general definition of materiality:

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement [FASB, 1980, p. xv].

Even though the FASB gives a subjective definition, accountants tend to quantify the concept of materiality. According to SFAC No. 2, "Materiality judgments are primarily quantitative in nature. They pose the question: Is this item large enough for users of the information to be influenced by it?" Research has established that most accountants view materiality in terms of net income, usually 5 to 10 percent [Pattillo and Siebel, 1974; Slipp, 1983].

Objective accounting standards for material items have been established for a few limited issues. For example, Accounting Principles Board Opinion (APB) No. 15 states that a reduction in earnings per share of less than three percent will not be material, such that the computation of diluted earnings per share will not be required.

### MATERIALITY IN THE COURTS

If accountants have had difficulty in formulating a general definition for materiality, it should not be surprising that the courts of the United States have applied varying standards for materiality. Like the profession, the courts have been required to determine what is material in each situation that is brought before a tribunal.

#### *Common Law*

The application of a legal standard of materiality to accountants is drawn from the common law of torts. Accountants have been sued for supplying misleading information under the com-

mon law remedies for misrepresentation and fraud. The Restatement of Torts 2d (1988) defines materiality in cases of fraudulent misrepresentation as follows:

§ 538(2) The matter is material if (a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.

Comments to this section of the Restatement provide that the materiality decision is a question of fact which is a "matter of judgment." Like the accounting profession, the common law recognizes that materiality must be determined on a case-by-case basis. An item is material under common law if "a reasonable man would have regarded the fact misrepresented to be important in determining his course of action" [Restatement § 538, Comment (e)].

### *Securities Laws*

The Security Exchange Acts of 1933 and 1934 created criminal and civil liability for certain actions and omissions. The Acts use the term "material" to describe the offenses involving misleading information, but never define what is material. Security regulations have attempted to give some guidance, stating

The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters which an average prudent investor ought reasonably to be informed before purchasing the security registered [17 C.F.R. § 230.405(1) and 240.12b-2, 1984].

It is under the securities acts that the courts have most often been asked to interpret the materiality of financial information. The courts' definition of materiality has varied depending upon the particular statute or regulation involved and the facts of each case.

### *Evolution of Materiality in Case Law*

Cases in which materiality has been an issue fall into three main categories, (1) trading on insider information, (2) omissions from financial or registration statements, and (3) omissions from

proxy materials. While not all of these cases have involved accountants, each has contributed to the definition of materiality in the courts.

*Insider Trading.* An early case involving trading on insider information is *Kardon v. National Gypsum Co.*, [73 F.Supp. 798 (E.D.Pa. 1947)]. In this case, a corporation was owned equally by four shareholders, two of whom served as officers. The two officers purchased the stock holdings of the other two shareholders without informing them that negotiations for the sale of the company had begun. Whether the pending sale was a material fact was an important issue in the case. The court stated that information was material if it would "affect the judgment of the other party to the transaction."

*List v. Fashion Park, Inc.*, [340 F.2d 457 (Cir. 2, 1965), cert. den. 382 U.S. 811], involved a similar insider trading allegation, with insiders purchasing the shares of a minority shareholder after information concerning a possible sale of the corporation became available. The court further developed the definition of materiality, stating,

The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. To put the matter conversely, insiders 'are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.' *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (Cir. 7, 1963).

*Financial or registration statements.* Accountants are most often defendants in cases which involve omissions from financial statements. An important case in this area is *Escott v. Barchris Construction Corp.*, [283 F.Supp. 643 (S.D.N.Y. 1968)]. In this case, a number of items were found to have been misstated in the financial statements of the corporation. These items included an overstatement of sales and income, an understatement of liabilities, and the omission of information concerning officer loans and delinquent customer accounts. In a controversial decision, the court found that some of the omissions were material, while others of similar magnitude were not. Overstatement of earnings per share by about 15% was found not be material. At the same time, balance sheet errors which resulted in a current ratio of 1.9:1, which if correctly stated would have been 1.6:1 were held to be material.<sup>1</sup> In making the materiality determination, the court de-

<sup>1</sup>For a critical discussion of the result see Briloff (1972), pp. 53-54.

finer "materiality" as those matters which

an investor needs to know before he can make an intelligent, informed decision. . . . The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are not of interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.

*Proxy Statements.* The Supreme Court of the United States has most often considered materiality under the Securities Acts in determining the validity of proxy solicitations. Important examples of the Supreme Court decisions involving proxies include: *J. I. Case Co. v. Borak*, [377 U.S. 426 (1964)]; *Mills v. Electric Auto-Lite Co.*, [396 U.S. 375 (1970)]; *TSC Industries, Inc. v. Northway, Inc.*, [426 U.S. 438 (1976)]. The facts of these proxy cases are similar, with a proposed corporate merger or acquisition as the subject of the controversy. In the *Mills* case, the Supreme Court, in *dicta*, made the following statement defining materiality:

Where the misstatement or omission in a proxy statement has been shown to be 'material,' as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote [Emphasis added.] [396 U.S. 375, 384.]

This statement caused confusion in the lower courts when applying the materiality standard.<sup>2</sup> In *TSC Industries v. Northway*, the Supreme Court clarified the definition of materiality in proxy statement cases. The standard of disclosure is not those items which *might* be considered important to a shareholder. Instead, the Supreme Court defined materiality under this securities regulation as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote. . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote [Emphasis added.] [426 U.S. 406, 409.]

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<sup>2</sup>In *Smallwood v. Pearl Brewing Co.*, 489 F.2d 597 (Cir. 5, 1974), the lower court discusses the problems with the *Mills* definition.

## JUDICIAL DEFINITION OF MATERIALITY

There remain differences in the definition of materiality as applied by the courts. These differences can be summarized as follows:

- 1) Would the information have actually *influenced* the actions of another or would the information only be considered *important* to another?
- 2) Who must be affected by the error or omission, the average *investor* or the reasonable *layman*?
- 3) Who must be affected by the error or omission, the *prudent* investor or the *speculative* investor?

In Table 1, the variations in the elements of the definition, as interpreted by the courts in selected cases, are presented.

An analysis of past court cases reveals that these differences depend, for the most part, on the subject matter of the litigation and the particular section or regulation under the securities laws involved. However, trends which have developed over time can also be seen.

### *Analysis of the Court-Derived Materiality Standard*

"*Influence*" or "*Important*". In determining the standard for materiality decisions, the courts have sometimes required that material information be significant enough that it would affect the decision of the recipient of the information. Examples of these cases include *Kardon v. National Gypsum Co.*, supra; *Kohler v. Kohler Co.*, supra; *List v. Fashion Park*, supra; *Crane Co. v. Westinghouse Air Brake Company*, [419 F.2d 787 (Cir. 2, 1969)].

In other cases, information has been held to be material if it were important to the recipient in making his decision, regardless of whether it would have caused him to act differently. Examples of these cases include *SEC v. Texas Gulf Sulfur*, [401 F.2d 833 (Cir. 2, 1967), cert. den. 394 U.S. 976]; *Affiliated Ute Citizens of Utah v. United States*, [406 U.S. 89 (1972)], *Mills v. Electric Auto-Lite*, supra; *TSC Industries v. Northway*, supra. This "important" threshold test requires that additional information be revealed and places a higher standard on accountants. While some controversy has existed over whether information which "might" be considered important or which "would" be considered important should be revealed, the Supreme Court clarified the standard in *TSC Industries v. Northway*. In that case, the Court declared that only the information which *would* be considered important should be required.

**Table 1**  
**Opinions on the Elements of Materiality**

	<b>"Influence" v. "Important"</b>	<b>"Layman" v. "Investor"</b>	<b>"Speculative" v. "Prudent"</b>
<i>Accounting Profession</i> SFAC No. 2	Influence or Important	Layman	Prudent
<i>Common Law</i> Restatement of Torts	Important	Layman	Prudent
<i>Court Cases Under Securities Laws*</i>			
<i>Kohler v. Kohler Co.</i> , Cir. 7, 1963 (131)	Influence	Layman	Prudent
<i>List v. Fashion Park</i> , Cir. 2, 1965 (266)	Influence	Layman	Prudent
<i>Escott v. Barchris Construction Corp.</i> , S.D.N.Y., 1968 (61)	Influence	Investor	Prudent
<i>SEC v. Texas Gulf Sulphur</i> , S.Ct., 1968 (565)	Important	Investor	Speculative
<i>Mills v. Electric Auto-Lite</i> , S.Ct., 1970 (827)	Important	Investor	Prudent
<i>Gerstle v. Gamble- Skogmo</i> , Cir. 2, 1973 (143)	Influence	Investor	Prudent
<i>Smallwood v. Pearl Brewing Co.</i> , Cir. 5, 1974 (147)	Important	Layman	Prudent
<i>TSC Industries v. Northway</i> , S.Ct., 1976 (597)	Important	Investor	Prudent

\* This list of cases is not intended to be inclusive, but to provide a representative sample only. The number in parenthesis indicates the number of cases which have cited each case, as determined by LEXIS search. These high numbers of citations are indicative of the importance of these cases.



Table 1, which summarizes the positions of the courts, reveals a trend over time. The courts appear to be moving away from the standard that information must influence another's actions in order to be material. Instead, the more recent decisions have required that any important information be considered material. While this places a higher burden on the accounting profession, at least the Supreme Court has refused to apply an even higher standard which would require disclosure of all information which *might* be considered important.<sup>3</sup>

"Investor" or "Layman". The common law standard for misrepresentation is that of the hypothetical "reasonable man." This standard has sometimes been adopted by the courts in applying the definition of materiality to financial information.<sup>4</sup> As stated by the court in *Smallwood v. Pearl Brewing Co.*,

... the test of materiality is 'whether a reasonable man would attach importance to the fact misrepresented in determining his course of action.' This definition, born of the Restatement of Torts, § 538(2)(a), has a rich history of application to the securities laws. [Citations omitted.] It has not been and should not be discarded as a standard. [489 F.2d 579, 604 (Cir. 5, 1974), cert. den. 419 U.S. 873].

The courts have also applied the standard of the "average prudent investor." Under this standard, the user of financial information can be assumed to have some basic knowledge of investment activities.<sup>5</sup> Whether this is a higher or lower standard than that of the "reasonable man" depends on the facts. In some situations, a layman might require a more thorough explanation of the activities of a company. At other times, a knowledgeable investor might demand that more information be disseminated.

Again, a trend over time appears to have developed under the securities laws. Recent cases tend to apply the standard of the "average prudent investor."

"Prudent" or "Speculative". In some special situations, an even higher standard of materiality may be required. In *SEC v. Texas Gulf Sulphur Co.*, *supra*, the materiality of reports on mining explorations which were not disclosed to the public prior to in-

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<sup>3</sup>Note that the Supreme Court cases which have recently ruled in the area of materiality have all considered misinformation or omissions in proxy statements under Rule 14a-9 of the securities regulations. It is possible that a different standard could apply if another topic were considered.

<sup>4</sup>For a discussion of the layman and the securities acts, see Kripke (1973).

<sup>5</sup>Jennings, et. al. (1985) discuss this difference in the application of the rule.

sider purchases was in dispute. Relying upon the legislative history of the securities acts, the court stated that this information "would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold." [401 F.2d 833, 850 (1968)].

While the definition of materiality applied by the court in *Texas Gulf Sulphur* is unusual, it should not be ignored.<sup>6</sup> Because materiality decisions are made on a case-by-case basis, all the facts and circumstances of a company must be considered. As stated by the court,

whether facts are material . . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. [401 F.2d 833, 849 (1968)].

### *Summary of the Judicial Definition of Materiality*

From an analysis of judicial decisions, the best general definition of materiality which can be developed is that items will be material if the average prudent investor would consider the information important in evaluating his course of action. However, variations of this definition can occur, depending on the facts and circumstances of each case and the issue involved. Accountants should keep in mind these possible variations of the materiality standard in the courts. Taking these less often applied variations into consideration, the judicial test for materiality is better stated as follows: Would the average reasonable [or speculative] investor [or layman] consider important [or be influenced by] this information in determining his course of action.

## CONCLUSIONS AND COMMENTS

The accounting profession and the judicial system have had difficulty in formulating a general definition of materiality. Both recognize that decisions must be made on a case-by-case basis. However, accountants and the courts approach the problem differently. Accountants tend to evaluate information quantitatively. Decisions as to materiality are made in terms of the comparative magnitude of the information. The courts apply a qualitative stan-

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<sup>6</sup>For a critical discussion of the result, see Kripke (1971).

dard, looking at the use of the information by the readers of financial statements. For the courts, the magnitude of the item may be one factor to consider in determining materiality, but it is not a controlling factor.

Accountants may be unsettled by what appears to be a lack of uniformity in the courts when defining materiality. However, the U.S. judicial system causes some of the differences evident in the court cases. When courts in various jurisdictions are approached to determine issues of materiality, different precedents are set. Only the standards set in the decisions of the Supreme Court are applied universally. Another factor which creates differences in court cases is that materiality has been an issue in many types of cases. In making materiality determinations, the courts have scrutinized various statutes and regulations within the body of the securities laws. This paper has concentrated on the definition of materiality in the courts and has not investigated the varying nuances evident in different sections of the securities act and regulations. Thus, the problem with the varying standards of materiality may lie within the regulations and not with the evaluation by the courts.

Because materiality is determined based upon the facts and circumstances of each case, differences in its application can be expected to continue. The courts might be more likely to apply a universal standard if the accounting profession could first develop a specific definition to be applied. As stated by the court in *U.S. v. Simon*, [425 F.2d 796, 807 (Cir. 2, 1969)]:

We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment . . . [Emphasis added.]

As long as materiality decisions are made on a case-by-case basis under different common and statutory law standards, differences in the application of the rule by the courts will continue.

Even though the accounting profession has developed its own view of materiality, the judicial definition cannot be ignored. In today's litigious society, if an accountant's judgment is questioned, the ultimate determination of proper treatment is often made by the courts. To avoid legal liability, accountants must comply with the common law definition of materiality as it has evolved. Therefore, accountants are compelled to adopt the judicial definition of

materiality, though it may not always agree with the profession's conceptual framework of accounting.

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